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Dealing with Distressed Properties and Loans – A Refresher

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The pandemic-induced economic downturn has created huge stresses on owners of both residential and commercial real property. In turn, those stresses have been visited upon the lenders who have financed those properties. Contrary to the beliefs of some borrowers, lenders would much prefer a performing loan to a foreclosure. However, not every workout attempt is successful, and this article provides a refresher on voluntary workouts and foreclosures.

Before beginning workout discussions, lenders should consider entering into a pre-negotiation agreement. These agreements set the ground rules for workout discussions and typically include provisions favorable to lenders, such as the borrower's acknowledgement and reaffirmation of the debt, waiver of defenses, and release of claims against the lender. In exchange for these concessions, borrowers will often ask the lender to simultaneously enter into a forbearance agreement in which the lender agrees to delay exercise of remedies and postpone or reduce repayment amounts.

If returning the loan to performing status is not possible, lenders should consider voluntary resolutions short of foreclosure. In Minnesota, these resolutions include accepting a deed in lieu of foreclosure or conducting a voluntary foreclosure sale pursuant to Minnesota Statutes Section 582.32. The main benefit to a lender of accepting a "deed in lieu" is obtaining title to the mortgaged property quickly. However, lenders considering a deed in lieu should think carefully about whether they truly wish to own the mortgaged property. In some circumstances, issues associated with the property, such as environmental concerns, make taking title to the collateral less attractive. Before accepting a deed in lieu, lenders and their counsel should also determine whether there are any junior creditors claiming a lien on the mortgaged property. If a foreclosure to remove junior liens will be necessary, a deed in lieu becomes less attractive.

Voluntary foreclosures are available for commercial properties and involve both lender and borrower agreeing to forego certain rights. For instance, the lender agrees to waive a deficiency judgment, and the borrower agrees to waive its rights to "reinstate" the loan by making the missed payments. The main advantages of a voluntary foreclosure are the reduction of the publication period prior to the foreclosure sale from six weeks to four and shortening the redemption period from the typical six months to two.

If a nonvoluntary foreclosure becomes necessary, Minnesota Statutes allow for nonjudicial foreclosure, commonly known as “foreclosure by advertisement,” and judicial foreclosure, commonly known as “foreclosure by action.” Foreclosure by advertisement involves publication of a notice of sale in a legal newspaper followed by a sheriff’s sale. Because it does not involve litigation, foreclosure by advertisement is generally faster and cheaper than foreclosure by action. However, foreclosure by action (which involves litigation in district court) can be necessary if there are defects in the mortgage that preclude foreclosure by advertisement. Further, foreclosure by action is also preferable if there are questions of lien priority, the lender desires a deficiency judgment, or other issues exist that require a judicial stamp of approval before the property is sold at a sheriff’s sale.

Minnesota law provides borrowers with the ability to redeem following the foreclosure sale by paying the amounts bid at the sale, plus interest and costs. Redemption rights apply in both foreclosure by advertisement and foreclosure by action. The most common redemption period is six months. If, however, the property is agricultural or over 40 acres in size, or more than 33 percent of the original loan amount has been paid, the redemption period is extended to 12 months. Lenders faced with a troubled loan have many options available to them, including returning the loan to performing status or, if that is not possible, the lender’s foreclosure options.